Financial Markets and Institutions

Abridged 10th Edition

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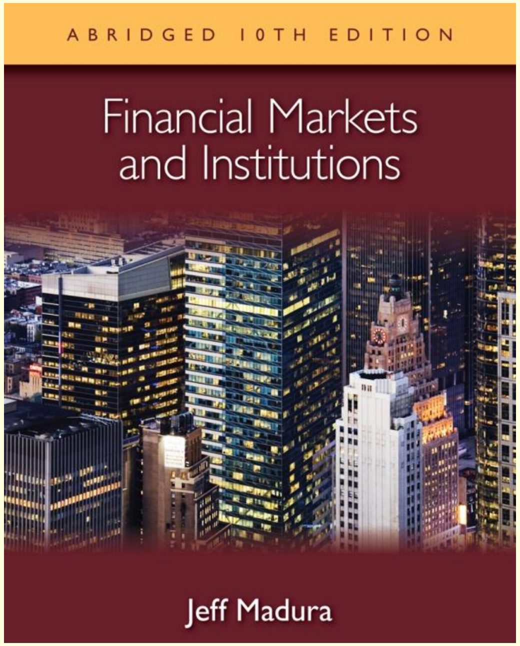
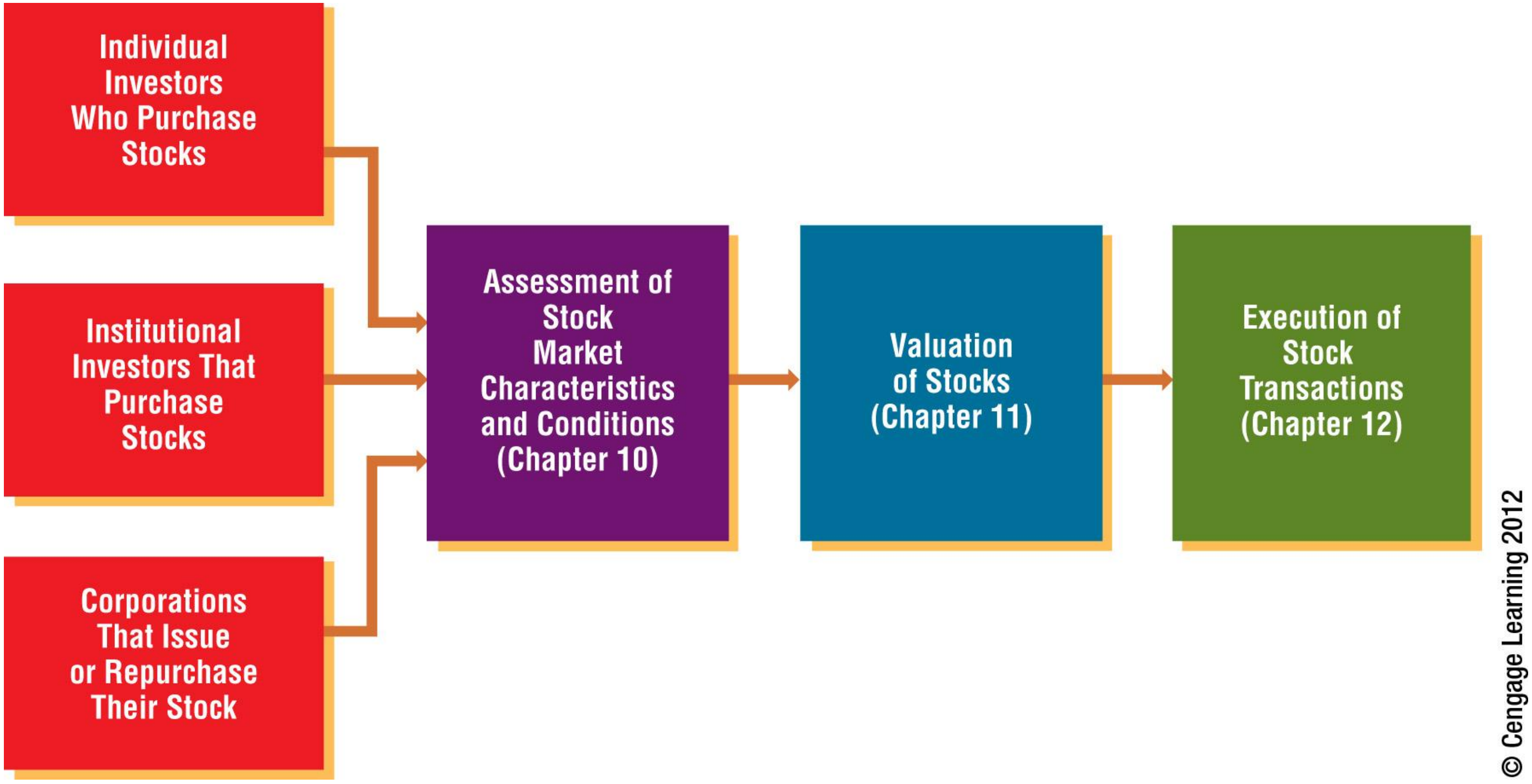


Part 4 Equity Markets



10 Stock Offerings and Investor Monitoring

Chapter Objectives

- describe the private equity market
- describe investor participation in the stock markets
- describe the process of initial public offerings
- describe the process of secondary offerings
- explain how the stock market is used to monitor and control firms
- describe the globalization of stock markets

Private Equity

Private equity is a business that is privately held and the owners cannot sell their shares to the public.

Some business owners hope to go public so that:

- They can obtain financing to support the firm's growth
- They can "cash out" by selling their original equity investment to others.

A public offering is feasible if:

- The owners want to sell at least $50 million in stock.
- The shareholder base will be large enough to support an active secondary market.

Private Equity

Financing by Venture Capital Funds

- Venture capital funds (VC funds) receive money from wealthy investors and from pension funds that are willing to maintain the investment for a long-term period, such as 5 or 10 years.
- Investors are not allowed to withdraw their money before a specified deadline.

Private Equity

Venture Capital Market

- Brings together the private businesses that need equity funding and the VC funds that can provide funding.

Terms of a Venture Capital Deal

- A VC fund will negotiate the terms of the deal when it decides to invest in a business.
- The VC fund will set out requirements for the business and VC fund managers may serve as advisers to the business.

Private Equity

Exit Strategy of VC Funds

- VC funds typically plan to exit in 4 to 7 years by selling the equity stake to the public.

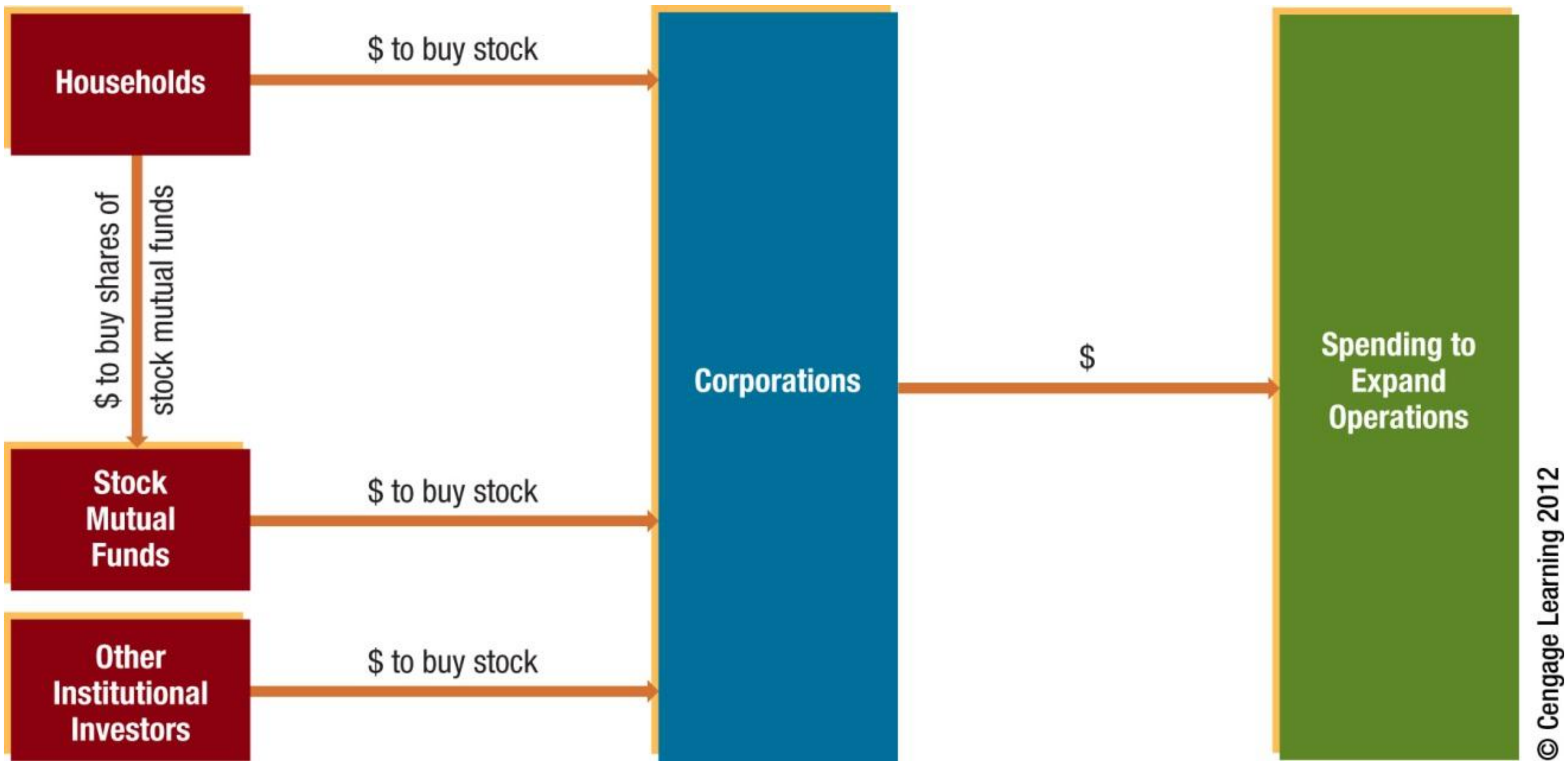
Financing by Private Equity Funds

- Private equity funds pool money provided by institutional investors (such as pension funds and insurance companies) and invest in businesses.
- They also rely heavily on debt to finance their investments.

Public Equity

- When a firm goes public, it issues stock in the **primary market** in exchange for cash.
- Going public has two effects on the firm.
  - It changes the firm's ownership structure by increasing the number of owners.
  - It changes the firm's capital structure by increasing the equity investment in the firm.
- Stock markets are like other financial markets in that they link the surplus units (that have excess funds) with deficit units (that need funds).
- The **secondary market** allows investors to sell the stock they previously purchased to other investors.

Exhibit 10.1 How Stock Markets Facilitate the Flow of Funds



Ownership and Voting Rights

- Owners of small companies also tend to be the managers. In publicly traded firms, most shareholders are not the managers.
- Ownership of common stock entitles shareholders to a number of rights.
  - Normally, only the owners of common stock are permitted to vote on certain key matters concerning the firm.
  - Many investors assign their vote to management through the use of a **proxy**.

Preferred Stock

- **Preferred stock** represents an equity interest in a firm that usually does not allow for significant voting rights.
- Preferred shareholders share the ownership of the firm with common shareholders and are therefore compensated only when earnings have been generated.
- A cumulative provision on most preferred stock prevents dividends from being paid on common stock until all preferred stock dividends have been paid.
- Because the dividends on preferred stock can be omitted, a firm assumes less risk when issuing it than when issuing bonds.
- Dividends are not tax-deductible for the firm, making preferred stock less desirable than bonds.

Participation in Stock Markets

- **How Investor Decisions Affect Stock Prices**
  - When there is a shift in the demand for shares or the supply of shares for sale, the equilibrium price changes.
  - Overall, the prevailing market price is determined by the participation of investors in aggregate.
- **Investor Reliance on Information**
  - In general, favorable news about a firm's performance will make investors believe that the firm's stock is undervalued at its prevailing price.
  - Information is incorporated into stock prices through its impact on investors' demand for shares and the supply of shares for sale by investors.

Exhibit 10.2 Institutional Use of Stock Markets

TYPE OF FINANCIAL INSTITUTION	PARTICIPATION IN STOCK MARKETS
Commercial banks	• Issue stock to boost their capital base. • Manage trust funds that usually contain stocks.
Stock-owned savings institutions	• Issue stock to boost their capital base.
Savings banks	• Invest in stocks for their investment portfolios.
Finance companies	• Issue stock to boost their capital base.
Stock mutual funds	• Use the proceeds from selling shares to individual investors to invest in stocks.
Securities firms	• Issue stock to boost their capital base. • Place new issues of stock. • Offer advice to corporations that consider acquiring the stock of other companies. • Execute buy and sell stock transactions of investors.
Insurance companies	• Issue stock to boost their capital base. • Invest a large proportion of their premiums in the stock market.
Pension funds	• Invest a large proportion of pension fund contributions in the stock market.

Initial Public Offerings

A first-time offering of shares by a specific firm to the public.

1. Process of Going Public

a. The issuer must **develop a prospectus** containing detailed information about the firm, including financial statements and a discussion of risks. The prospectus is filed with the Securities and Exchange Commission (SEC).

b. The lead underwriter must determine the **offer price** at which the shares will be offered at the time of the IPO.

c. **Allocation of IPO Shares**: The lead underwriter may rely on a group (called a syndicate) of other securities firms to participate in the underwriting process and share the fees to be received for the underwriting.

d. **Transaction Costs -** Usually 7 percent of the funds raised.

Exhibit 10.3 Summary of Bookbuilding Process Just before the IPO

POSSIBLE OFFER PRICE	TOTAL SHARES DEMANDED	TOTAL PROCEEDS TO ISSUER
$13	3,000,000	$39,000,000
$12	3,500,000	$42,000,000
$11	4,000,000	$44,000,000
$10	4,300,000	$43,000,000

2. Underwriter Efforts to Ensure Price Stability

a. Underwriters may attempt to stabilize the stock’s price by purchasing shares that are for sale in the secondary market shortly after the IPO.

b. Lockup

i. Prevents the original owners of the firm and the VC firms from selling their shares for a specified period.

ii. Prevents downward pressure that could occur if the original owners or VC firms immediately sold their shares in the secondary market.

3. Timing of IPOs

Initial public offerings tend to occur more frequently during bullish stock markets.

Initial Public Offerings

4. Initial Returns of IPOs

a. The initial (first-day) return of IPOs in the United States has averaged about 20 percent over the last 30 years.

b. Flipping Shares

i. Investors flip shares by buying the stock at its offer price and selling the stock shortly afterward.

ii. If many institutional investors flip their shares, the market price of the stock may decline shortly after the IPO.

5. Google's IPO

a. On August 18, 2004, Google engaged in an IPO that generated $1.6 billion.

b. Estimating the Stock's Value - investors multiplied Google's earnings per share by Yahoo!'s price-earnings ratio.

c. Google's Communication to Investors before the IPO - Google provided substantial financial information about its operations and recent performance.

d. The Auction Process – Google used a Dutch auction process allowing all investors to submit a bid for its stock by a specific deadline.

e. Results of Google's Dutch Auction - resulted in a price of $85 per share.

f. Trading after the Auction - took place in the secondary market.

6. Abuses in the IPO Market

a. **Spinning** - occurs when the underwriter allocates shares from an IPO to corporate executives who may be considering an IPO or to another business that will require the help of a securities firm.

b. **Laddering** - brokers encourage investors to place first-day bids for the shares that are above the offer price. This helps to build upward price momentum investors multiplied Google’s earnings per share by Yahoo!’s price-earnings ratio.

c. **Excessive Commissions** - Some brokers have charged excessive commissions when demand was high for an IPO. Investors were willing to pay the price because they could normally recover the cost from the return on the first day.

Initial Public Offerings

7. Long-Term Performance Following IPOs

a. There is strong evidence that, on average, IPOs of firms perform poorly over a period of a year or longer.

b. From a long-term perspective, many IPOs are overpriced at the time of the issue.

c. This weak performance may be partially attributed to irrational valuations at the time of the IPO, which are corrected over time.

8. Impact of the Sarbanes-Oxley Act on IPOs

a. Requires that a firm have an internal control process in place one year before going public.

b. Since it went into effect, investors have made their decisions based on financial information rather than hype.

Stock Offerings and Repurchases

1. Secondary Stock Offerings

a. A secondary stock offering is a new stock offering by a specific firm whose stock is already publicly traded.

b. Corporations sometimes direct their sales of stock toward their existing shareholders by giving them **preemptive rights.**

c. **Shelf Registration** - Corporations can publicly place securities without the time lag often caused by registering with the SEC.

2. Stock Repurchases

a. Firms tend to repurchase some of their shares when share prices are at very low levels.

b. Many stock repurchase plans are viewed as a favorable signal, some investors may ask why the firm does not use its funds to expand its business instead of buying back its stock.

Stock Exchanges

1. Organized Exchanges

a. Each organized exchange has a trading floor where floor traders execute transactions in the secondary market for their clients.

b. New York Stock Exchange (NYSE) is by far the largest with two broad types of members.

   i. Floor brokers are either commission brokers or independent brokers.

   ii. Specialists can match orders of buyers and sellers.

c. **Listing Requirements -** minimum number of shares outstanding and a minimum level of earnings, cash flow, and revenue over a recent period.

2. Over-the-Counter Market

a. Stocks not listed on the organized exchanges are traded in the over-the-counter (OTC) market.

b. Nasdaq - National Association of Securities Dealers Automatic Quotations (Nasdaq), which is an electronic quotation system that provides immediate price quotations.

c. OTC Bulletin Board - lists stocks that have a price below $1 per share, which are sometimes referred to as penny stocks.

d. Pink Sheets - The OTC market has where even smaller stocks are traded. Some of the stocks have very little trading volume and may not be traded at all for several weeks.

Stock Exchanges

3. Extended Trading Sessions

a. The NYSE and Nasdaq market offer extended trading sessions beyond normal trading hours.

b. Market liquidity during the extended trading sessions is limited.

4. Stock Quotations Provided by Exchanges

a. **52-Week Price Range** - The stock's highest price and lowest price over the previous 52 weeks are commonly listed just to the left of the stock's name.

b. **Symbol** - Each stock has a specific symbol that is used to identify the firm.

c. **Dividend** - The annual dividend (DIV) is commonly listed to the right of the firm's name and symbol.

d. **Dividend Yield** - Annual dividend per share as a percentage of the stock's prevailing price. Shown next to the annual dividend.

e. **Price-Earnings Ratio** - Represents its prevailing stock price per share divided by the firm's earnings per share (earnings divided by number of existing shares of stock) generated over the last year.

Exhibit 10.4 Example of Stock Price Quotations

YTD % CHANGE	HI	LO	STOCK	SYM	DIV	YLD%	PE	VOL 100S	LAST	NET CHG
+10.3	121.88	80.06	ZIKARD CO.	ZIK	.56	.6	20	71979	93.77	+1.06
Year-to-date percen-tage change in stock price	High-est price of the stock in this year	Lowest price of the stock in this year	Name of stock	Stock symbol	Annual dividend paid per year	Dividend yield, which repre-sents the annual dividend as a percen-tage of the prevailing stock price	Price–earnings ratio based on the pre-vailing stock price	Trading volume during the previous trading day	Clos-ing stock price	Change in the stock price from the close on the day before

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4. Stock Quotations Provided by Exchanges (Cont.)

f. **Volume** - Stock quotations also usually include the volume of shares traded on the previous day. The volume is normally quoted in hundreds of shares.

g. **Closing Price Quotations** - Stock quotations show the closing price ("Last") on the day (on the previous day if the quotations are in a newspaper). In addition, the change in the price ("Net Chg") is typically provided and indicates the increase or decrease in the stock price from the closing price on the day before.

5. Stock Index Quotations

a. **Dow Jones Industrial Average** - value-weighted average of stock prices of 30 large U.S. firms.

b. **Standard & Poor's 500** - a value-weighted index of stock prices of 500 large U.S. firms.

c. **Wilshire 5000 Total Market Index** - index now contains more than 5,000 stocks. The Wilshire 5000 is the broadest index of the U.S. stock market.

d. **New York Stock Exchange Indexes -** The Composite Index is the average of all stocks traded on the NYSE. NYSE also provides indexes for four sectors: Industrial, Transportation, Utility, Financial.

e. **Nasdaq Stock Indexes** - The National Association of Securities Dealers (NASD) provides quotations on indexes of stocks traded on the Nasdaq.

Monitoring Publicly Traded Companies

- The easiest way for shareholders to monitor the firm is to monitor changes in its value (as measured by its share price) over time.
- If the stock price is lower than expected, shareholders may attempt to take action to improve the management of the firm.
- Investors also rely on the board of directors of each firm to ensure that its managers make decisions that enhance the firm's performance and maximize the stock price.

Monitoring Publicly Traded Companies

1. Role of Analysts

a. Analysts are often employed by securities firms and assigned to monitor a small set of publicly traded firms.

b. **Stock Exchange Rules -** In the 2002–2004 period, U.S. stock exchanges imposed new rules to prevent some obvious conflicts of interest faced by analysts.

i. Analysts cannot be supervised by the division that provides advisory services, and their compensation cannot be based on the amount of advisory business they generate.

ii. Securities firms must disclose summaries of their analysts' ratings for all the firms that they rate so that investors can determine whether the ratings are excessively optimistic.

Monitoring Publicly Traded Companies

2. Accounting Irregularities

a. In recent years, many firms used unusual accounting methods to create their financial statements.

b. Overall, investors’ monitoring of some firms was limited because the accountants distorted the financial statements, the auditors did not properly audit, and the audit committees of those firms did not properly oversee the audit.

3. Sarbanes-Oxley Act

a. Prevents a public accounting firm from auditing a client firm whose chief executive officer (CEO), chief financial officer (CFO), or other employees with similar job descriptions were employed by the accounting firm within one year prior to the audit.

b. Requires that only outside board members of a firm be on the firm's audit committee, which is responsible for making sure that the audit is conducted in an unbiased manner.

c. Prevents the members of a firm's audit committee from receiving consulting or advising fees or other compensation from the firm beyond that earned from serving on the board.

3. Sarbanes-Oxley Act (Cont.)

d. Requires that the CEO and CFO of firms of a specified size (or larger) certify that the audited financial statements are accurate.

e. Specifies major fines or imprisonment for employees who mislead investors or hide evidence.

f. Allows public accounting firms to offer nonaudit consulting services to an audit client only if the client's audit committee pre-approves the nonaudit services to be rendered before the audit begins.

Cost of Being Public

Establishing a process that satisfies the Sarbanes-Oxley provisions can be very costly. For many firms, the cost of adhering to the guidelines of the act exceeds $1 million per year.

4. Shareholder Activism

a. If shareholders are displeased with the way managers are managing a firm, they have three choices.

   i. Do nothing and retain their shares.
   ii. Sell the stock.
   iii. Engage in shareholder activism

b. **Communication with the Firm** - Shareholders can communicate their concerns to other investors in an effort to place more pressure on the firm's managers or its board members.

c. **Proxy Contest** - Shareholders may also engage in proxy contests in an attempt to change the composition of the board.

d. **Shareholder Lawsuits** - Investors may sue the board if they believe that the directors are not fulfilling their responsibilities to shareholders.

Monitoring Publicly Traded Companies

5. Limited Power of Governance

a. There is some evidence that the governance is not very effective.

b. In spite of the Sarbanes-Oxley Act, shareholder activism, proxy contests, and shareholder lawsuits, the agency problems of some firms remain severe.

Market for Corporate Control

1. Use of LBOs to Achieve Corporate Control

The market for corporate control is enhanced by the use of **leveraged buyouts (LBOs)**, which are acquisitions that require substantial amounts of borrowed funds.

2. Barriers to the Market for Corporate Control

a. **Antitakeover Amendments** - an amendment may require that at least two-thirds of the shareholder votes approve a takeover.

b. **Poison Pills** - Special rights awarded to shareholders or specific managers on the occurrence of specified events.

c. **Golden Parachutes** - specifies compensation to managers in the event that they lose their jobs or change in control of the firm.

Globalization of Stock Markets

1. **Privatization** - In recent years, the governments of many countries have allowed privatization, or the sale of government-owned firms to individuals.
2. **Emerging Stock Markets** - Emerging markets enable foreign firms to raise large amounts of capital by issuing stock.
3. **Variation in Characteristics across Stock Markets** - The volume of trading activity in each stock market is influenced by legal and other characteristics of the country. Shareholder rights vary among countries, and shareholders in some countries have more voting power and can have a stronger influence on corporate management.

Globalization of Stock Markets

4. Methods Used to Invest in Foreign Stocks.

a. **Direct Purchases -** Investors can easily invest in stocks of foreign companies that are listed on the local stock exchanges.

b. **American Depository Receipts -** certificates representing shares of non-U.S. stock. Many non-U.S. companies establish ADRs in order to develop name recognition in the United States.

c. **International Mutual Funds -** portfolios of international stocks created and managed by various financial institutions.

d. **International Exchange-Traded Funds -** Passive funds that track a specific index. International ETFs represent international stock indexes, and they have become popular in the last few years.

SUMMARY

- When businesses are created, they normally rely on private equity along with borrowed funds. Some private businesses that expand attempt to obtain additional private equity funding from venture capital firms. When venture capital firms provide financing, they commonly attempt to pull their cash out in 4 to 7 years. Going public changes the firm's ownership structure by increasing the number of owners, and it changes the firm's capital structure by increasing the equity investment in the firm. Stock market participants include individual investors as well as institutional investors such as stock mutual funds, pension funds, and insurance companies. Upon the release of new information about a firm, some investors respond by either selling their stock holdings or buying more stock. Their actions affect the supply and demand conditions for the stock and thus influence the equilibrium stock price.

SUMMARY (Cont.)

- An initial public offering (IPO) is a first-time offering of shares by a specific firm to the public. Many firms engage in an IPO to obtain funding for additional expansion and to give the founders and venture capital funds a way to cash out their investments. A firm that engages in an IPO must develop a prospectus that is filed with the SEC, and it typically uses a road show to promote its offering. The firm hires an underwriter to help with the prospectus and road show and to place the shares with investors.

- A secondary stock offering is an offering of shares by a firm that already has publicly traded stock. Firms engage in secondary offerings when they need more equity funding to support additional expansion.

SUMMARY (Cont.)

- There are various ways in which publicly traded firms are monitored. Analysts monitor firms so that they can assign a rating to their stock. Investors that purchase stock of firms monitor performance and may use shareholder activism to ensure that managers make decisions that are beneficial to the firm’s shareholders. The market for corporate control allows firms to acquire the control of businesses that they can improve by replacing managers or revising operations.
- Many U.S. firms issue shares in foreign countries, as well as in the United States, so that they can spread their shares among a larger set of investors and possibly enhance the firm’s global name recognition. Global stock exchanges exist to facilitate the trading of stocks around the world. U.S. investors can invest in foreign stocks by making direct purchases on foreign stock exchanges, purchasing ADRs, investing in international mutual funds, and investing in international exchange-traded funds.